

10 steps to defusing loan-mod bombs (updated) (May 4, 2009)

Don't hurt your bank while helping borrowers

A special update to this article has been added, as of May 14, 2009. Please see the new material at the end of the article. Specifically, the information deals with Point #9, addressing collection of government monitoring information.

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There's more than one way to save a loan—and even more ways to mess up

Your regulator is encouraging you to work constructively with borrowers to prevent foreclosures, but don't forget that even bend-over-backwards loans remain fully subject to all applicable regulatory compliance requirements—no matter how flexible you are being to help your customers.

Many customers are feeling extreme economic stress and are looking for relief. They're seeking payment holidays, rate relief, and principal reductions. Mortgage lenders are responding by refinancing or modifying loans, and helping consumers avoid foreclosure. (See Cover Story, p. 5.) But, in the meantime, there is no compliance holiday, and banks must continue to be alert to—and comply with—all the regulatory compliance requirements that apply to mortgage loan modifications and restructurings.

Mistakes can have disastrous consequences. The victim consumer will seek help any way possible. This is no time for your bank to find itself the subject of headlines like: "Bank Fined for Violating Consumer Protection Laws" or "Bank Found to be Using Unfair Practices." The cause of those headlines could be as minor as a technical error on a form or a missed Notice to the Cosigner. Or it could be a credit discrimination lawsuit brought by a consumer who didn't get his mortgage loan modified and felt unfairly treated.

Here are ten compliance pitfalls associated with mortgage loan modifications that bankers must avoid.

1. Equal Credit Opportunity Act/Regulation B and the Fair Housing Act apply to ALL aspects of credit throughout the credit relationship.

Even after a loan is approved and on the books, a bank is still subject to ECOA/Regulation B and fair-lending laws. How a bank treats each borrower or groups of borrowers through the loan-servicing and loan-workout process will be judged under the same equal credit opportunity standards as when the loan application process first began. Banks must avoid any unequal or discriminatory treatment on any prohibited basis when determining which loans should be modified or refinanced, and how the resulting loans will be structured and priced.

To avoid this problem, develop and follow clear policies and procedures on loan marketing, underwriting, and pricing—and rewriting. Banks should have a defined plan for how to communicate loan modification program availability, handle customer requests, price the product, and determine qualifications. Some banks may be affirmatively soliciting consumers through advertising and active communications, while others may be waiting for customers to contact them.

Banks should know the demographic implications of each approach. Banks should decide how much discretion to allow loan officers in making changes to loans. If clear guidelines are not provided by management, the treatment among borrowers could vary significantly, and the bank could be subject to allegations of disparate treatment on a prohibited basis.

2. Adding cosigners, guarantors, and other signers

Banks may be tempted to shore up existing loans with additional signatures. If an additional signer for the loan is deemed necessary, the bank may not require that the borrower's spouse be the signer. However, the bank has the ability to evaluate the offered signer under its objective standards and determine if the signer is qualified. State laws should also be consulted, because state laws vary on spousal property rights and signatures needed for access to collateral.

The Notice to Cosigners under Regulation AA may be required if a cosigner is added to a loan—other than a mortgage loan—that is modified. The notice informs the consumer who is assuming liability for an obligation without receiving goods, services, or money of the implications of that obligation, and must be provided to the cosigner in order for the obligation to be valid. Failure to provide the Notice to Cosigners is considered an unfair or deceptive practice.

3. "Modification" vs. "refinancing" under Regulation Z and RESPA

Lenders may sometimes use the two terms interchangeably, but there is an important distinction between modification and refinancing for purposes of compliance loan disclosures.

If an existing obligation is satisfied, and then replaced by a new obligation undertaken by the same consumer, the new obligation is a "refinancing" that is subject to new Regulation Z and RESPA disclosures for the new obligation. On the other hand, modifying the terms of an existing consumer obligation does not trigger all new disclosures.

Now let's complicate things. There are certain new loan situations that would not be considered refinancings, even if there is a satisfaction of an existing loan with a new obligation. Example: If the new loan involves a reduced APR

and a corresponding reduction in the payment schedule, the new loan is not a refinancing under Reg Z. There is also an exemption for situations involving the consumer's default or delinquency. When in doubt, treat the loan as a refinancing and disclose.

Any finance charges that are imposed at this stage need to be identified. Loan modification fees are generally not finance charges, but fees for refinancing may be, depending on circumstances. If a loan is being refinanced and new loan disclosures apply, the timing of providing disclosures to consumers must be carefully observed. Many disclosures must be provided to consumers early in the loan process and—sometimes before a loan decision is made.

One further consideration is that a refinancing may be subject to rescission, while a modification is not. A new loan with the same lender is generally not rescindable except for an amount that exceeds the previous obligation. However, if you are refinancing a loan originally made by another lender, be sure to follow procedures for rescission.

4. Flood insurance obligations rise again

If a loan is made, increased, renewed, or extended ("MIRE"), a new flood determination is required under flood insurance regulations. Any action that the lender takes to rewrite the loan triggers flood hazard insurance requirements. When a bank refinances a loan that it made originally, it may use a prior flood determination as long as: the prior determination is not more than seven years old; was properly documented on the Standard Flood Hazard Determination Form; and there have not been any new or revised flood maps issued during that period.

In the case of a loan modification that does not involve an increase in loan amount, or a renewal or extension of the maturity, a new flood determination is not required. However, a bank should always ensure that any required flood insurance continues to be in place and in an amount sufficient to meet the regulatory requirements. The lender should also confirm whether the life-of-loan coverage applies to the renewal without a new flood hazard determination.

5. Unfair and deceptive acts or practices

Unfair and deceptive practices of unscrupulous lenders contributed to today's serious mortgage problems. As a result, much more attention is being given to the quality and accuracy of information that lenders provide to consumers—from advertisements through disclosures. Fair advertising, while a concern in any promotional efforts, is particularly important for mortgage rewrites and modifications. Be sure that your marketing pieces include all required information, are clear and easily understood, and do not omit information that would be important for consumers to fully understand the nature and type of product.

The concepts of unfairness and deception can be used in a positive campaign. Consider a positive theme, such as "We tell you everything you need to know."

6. Suspicious activity and fraud monitoring

Mortgage fraud is at an all-time high. Some borrowers took out mortgages intending to commit fraud, while others may have dodged responsibilities that they found they couldn't handle. Banks may find themselves holding such mortgages with no remedy other than filing Suspicious Activity Reports. Banks must be alert to the fraud opportunities that the economic problems present and report suspicious activity to the regulators and appropriate law enforcement agencies. FinCEN has published guidance to help you identify and report types of mortgage fraud.

7. Tracking Community Reinvestment Act performance

Not all consumers who want their loans rewritten will be low- or moderate-income, but many will be. When your treatment of problem loans, whether foreclosure or refinancing, involves low- or moderate-income borrowers or neighborhoods, your actions could be a significant aspect of your CRA performance. Working with low- and moderate-income customers can make a difference not only to your CRA program, but—more importantly—help to stabilize neighborhoods.

There are CRA opportunities beyond the refinancing or making of loans. The service and investment tests present opportunities for financial and homeownership counseling, support for employment centers, and job training.

And there is also a risk to your CRA program, depending on how your bank responds to the credit needs presented in your community.

8. Fees may be restricted under state law

Federal law requires disclosure of fees, but state law specifies whether a fee may be charged and what limitations apply to those fees. Check the state laws where your bank does business to determine if fees are permitted for loan modifications or restructurings, before imposing any.

9. Collecting government monitoring information and HMDA reporting not permitted unless the loan is a refinancing

Unless there is a new loan that replaces an existing obligation, a loan is not a refinancing and is not subject to the Home Mortgage Disclosure Act. In that case, requesting borrowers to provide race, gender, and ethnicity information would be prohibited, because the loan does not meet the definition of a “refinancing” under HMDA. The loan would also not be reportable on the bank’s HMDA Loan Application Register. A modified loan is not subject to HMDA and collection of government monitoring information unless it qualifies as a “refinancing” under the law. [See the update and elaboration below.]

10. Nonpreferential treatment for insiders

Modifying a loan to an executive officer or other bank insider is not totally out of the question. It can be done so long as the insider is not given preferential treatment. A bank must be sure that any changes to the loan are based on credit underwriting standards that are not less stringent than those for non-insiders and that the bank can show that it is not treating the insider more favorably than unaffiliated borrowers in the same situation. Another reason for policies, procedures, and clear standards for handling loan modifications and be able to document consistent, fair treatment for all borrowers. BJ

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addressing collection of government monitoring information.

More help for mortgage modifiers

The "10 Steps to Defusing Loan-Mod Bombs" article (published online at www.ababj.com and in the May print and digital editions of ABA Banking Journal) cautions banks about the compliance traps that banks need to watch out for when helping consumers with mortgage refinancings and modifications, including the prohibition under the Home Mortgage Disclosure Act (HMDA) against requesting government monitoring information (race, sex, and ethnicity) from borrowers for loan modifications. Banks that are following the Obama Administration's new Homeowner Affordability Modification Program (HAMP) have additional compliance challenges in knowing when the normal rules don't apply.

On April 21, 2009, the U.S. Treasury Department issued Supplemental Directive 09-02 that makes an exception to the normal rules concerning requests for government monitoring information for mortgage loans. The new directive requires loan servicers who are participating in the HAMP to request, as part of the HAMP Hardship Affidavit, the borrowers' race, ethnicity, and sex, even if the loan is not normally subject to data collection compliance requirements.

The process is familiar. The loan servicer is required to request the government monitoring information. If the borrowers elect not to provide the information, and the Hardship Affidavit is completed in a face-to-face interview, the servicer is required to record the information based on visual observation or surname. If the Hardship Affidavit is handled over the telephone, by internet, or through the mail, and the borrowers refuse to provide the information, the servicer is required to ask for the information, but not required to record it based on visual observation or surname.

The directive explains that the additional request for government monitoring information is authorized under the Equal Credit Opportunity Act and Regulation B, which allows a creditor to obtain information required by a regulation, order, or agreement issued by, or entered into with, a court or an enforcement agency (including the attorney general of the United States or a similar state official) to monitor or enforce compliance with the ECOA, Regulation B or other federal or state statutes or regulations. The Treasury Department intends to use the borrower characteristic information to monitor loan servicers' compliance with fair-lending laws.

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